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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961.

No. 719

In the matter of

GLOSTEN PROMOTIONS, INC.,

Bankrupt.

S. HARVEY KLEIN, Trustee of the bankrupt,

Petitioner,

vs.

IRVING HERMAN,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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The Scheffer Press, Inc.—ANdover 3-6850

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(a) None Of The Withholding Tax Funds Came Into The Personal Possession Of The Respondent, But Instead Were Used As A Part Of The General Funds Of The Debtor-In-Possession To Generate The Acquisition And Completion Of Merchandise And Accounts Receivable, And Then Turned Over In Full, Whether In The Form of

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S. HARVEY KLEIN, Trustee of the bankrupt,

Petitioner,

vs.

IRVING HERMAN,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The Trustee's Petition for Writ of Certiorari presents a distorted and twisted picture both as to the questions here presented for review, and as to the reasons advanced by the Trustee for the granting of the writ.

QUESTIONS PRESENTED FOR REVIEW.

The questions presented for review in this cause are simply these:

I.

Whether the summary proceedings had before the Referee in bankruptcy, and the Referee's order directing the respondent to pay to the bankrupt estate or the Director of Internal Revenue a sum necessary to satisfy the withholding tax claim of the United States against the bankrupt corporation, were in the nature of a turnover proceeding and order, and were so correctly construed both by the Court of Appeals and the District Court?

II.

Whether the Court of Appeals and the District Court were correct in holding in the instant case that a turnover order will not lie against the respondent to turn over that which he does not have and never had in his personal possession?

III.

Whether the Court of Appeals and the District Court were correct in holding that the debtor-in-possession's failure to segregate and pay withholding taxes for the last three months of its operations did *not* give rise to a cause of action, cognizable in a summary proceeding before the Referee, in favor of the Trustee against the respondent for an alleged breach of fiduciary duty, where, as here:

(a) None of the withholding tax funds, which the debtor-in-possession failed to segregate and pay for the 3 months in question, came into the personal possession of the respondent, but instead were used as a part of the general funds of the debtor-in-possession

to generate the acquisition and completion of merchandise and accounts receivables, and then turned over in full, whether in form of cash, merchandise or receivables, to the Trustee after the debtor-in possession had been adjudicated a bankrupt;

(b) There was no diversion of any of the withholding tax funds by the respondent for the personal use of the respondent;

(c) There was no proof or evidence of any loss or damage to the bankrupt estate, or to its creditors, by reason of the non-payment of said taxes;

(d) The finance company, financing the operations of the debtor-in-possession and having a first lien on all the assets of the debtor-in-possession by court order, virtually controlled the financial affairs of the debtor-in-possession during the three months period in question, and controlled the disbursement of all funds of the debtor-in-possession during this period.

(e) Respondent's conduct in relationship to the debtor-in-possession's failure to segregate and pay withholding taxes for the period in question, was found both by the Court of Appeals and the District Court *not* to constitute a deliberate and wilful defiance of the District Court's order, and *not* to constitue a willful breach of any fiduciary duty by the respondent; and

(f) The trustee had no lawful interest in the trust funds belonging to and claimed by the Director of Internal Revenue, and the Director of Internal Revenue is *not* asserting any claim against the respondent.

IV.

Whether the processes of the bankruptcy court should be used to persecute an officer of an insolvent bankrupt company merely to provide fees for Trustee and his counsel?

STATEMENT OF THE CASE.

The factual circumstances and background of this case are objectively set forth in the opinion rendered in this cause by the District Court for the Northern District of Illinois, Eastern Division (reported in 190 F. Supp. 538, and printed at pages 86 through 90 of the Appendix), and in the opinion of the United States Court of Appeals for the Seventh Circuit (reported in 295 F. 2d 324, and printed as Appendix "A" to petitioner's Petition for Writ of Certiorari), affirming the order of the District Court.

The pertinent factual findings contained in the opinion of the Court of Appeals are as follows:

> "This bankruptcy proceeding originated on April 22, 1957 when Glostex Products, Inc. filed its petition for an arrangement under Chapter XI of the Bankruptcy Act. On that date an order was entered permitting debtor to continue in possession of its property, and operate its business. On the same date a supplemental order was entered requiring debtor to segregate and deposit in a separate bank account all moneys withheld from employees' wages for taxes.
>
> "By order of April 29, 1957 debtor was authorized to borrow money from National Acceptance Company with which to carry on its business. In return National Acceptance Company received a first lien on all assets of debtor, including present or future accounts receivable.
>
> "Debtor fully complied with the order concerning taxes withheld from employees' wages through De-

cember, 1957. There was no segregation and deposit of these moneys for January, February and March, 1958.

"Debtor was adjudicated a bankrupt on April 21, 1958. Irving Herman was the general manager and the only active executive of debtor, Glostex Products, Inc.

"After adjudication of bankruptcy, the District Director of Internal Revenue sought an allowance of $9,634.18, representing withholding taxes for the three months when they were not deposited, as a special trust fund for the United States. Although the exact amount of the taxes was in dispute, the propriety of the Director's claim was conceded and is not questioned here. In response to the Director's claim, the trustee sought an order requiring Irving Herman to pay the amount of the claim of the United States for the withholding taxes. At the hearing which followed, the undisputed testimony of Herman disclosed that during the three months when the withholding taxes were not deposited, the financial affairs of debtor were virtually controlled by National Acceptance Company. All disbursements were subject to approval by this finance company. All checks drawn on debtor's account were subject to prior approval by National. In February, National began to open debtor's mail and withdraw all checks. Herman testified that when he requested funds from National with which to pay withholding taxes he was told that it would be taken care of. He admitted that he had never written a check with which to deposit the taxes nor had he been ordered not to do so. Nevertheless, it is apparent that Herman entertained a belief that National would not allow the taxes to be paid.

"As a result of the hearing, the referee found that Herman, as operating head of debtor, had deliberately failed to segregate and deposit the withholding taxes and ordered him to pay to the estate or the Director

of Internal Revenue the amount necessary to satisfy the claim of the United States.

"On petition for review, the district court construed the referee's order as a turnover order and held that the requisite possession upon which to premise such an order had not been shown. The district court, therefore, vacated the referee's order. It is this decision which is in question here.

"The trustee contends that Herman was a fiduciary with respect to the operation of the debtor in possession, that he breached his duty by failing to deposit the withholding taxes, and is thus personally liable for the amount due the United States. Herman contends that the district court was correct in its construction of the referee's order as a turnover order, and that the requisite possession has not been shown."

* * *

"In its memorandum opinion the district court further found and determined:

> 'The debtor [Herman] in the instant case is not accused of withdrawal of funds for his personal use. It is charged he used money for the purchase of merchandise from suppliers when he should have set aside some of the funds for taxes. The record is clear he derived no personal gain and in fact disbursed the money he received. This debtor [Herman] can not be ordered to turn over that which he does not possess.
>
> 'The record of this case discloses that from April 1957 through December 1957 the debtor [Herman] fully complied with the order of the Referee on withholding and social security taxes. It further shows that commencing in January the finance company reduced the amount of money being advanced to the debtor [Herman] and that it exercised control over the manner of its disbursement, hampering the debtor [Herman] in the exercise of his discretion as to the allocation

to be made of the moneys so advanced. Considering the entire record, this court is of the opinion that the debtor [Herman] should have brought this situation to the attention of the court earlier, but that this omission was not a deliberate and wilful defiance of the Referee's order."

"Our consideration of the record in this proceeding leads us to conclude that the district court did not err in so finding.

"Under the circumstances of this case, we hold that there was no willful breach of any fiduciary duty by Herman."

The District Court, in its opinion, had further found (App. 87):

"The testimony of the debtor discloses that he had no control over the receipt or collection of money from the operation of the business, which were all under the control of the finance company; that the only money he received for the operation of the business was that obtained from the finance company; that in January, 1958 the finance company began to reduce the amount of money it advanced to the debtor and required it to list its daily money requirements upon which the finance company indicated its approval and disapproval before disbursements were made; that during the early part of February the National Acceptance Corporation sequestered the mail of the debtor and withheld from the debtor all checks; that it also exercised control over the bank account of the debtor with the American National Bank by allowing or disallowing the clearance of checks that had been issued by the debtor for various purposes; that the debtor made frequent requests of the finance company to allow for the payment of the withholding and social security taxes and was advised that it would be taken care of; that in March the debtor advised its counsel that it was not receiving full

financing from the finance company, whereupon it was determined that the debtor in possession could no longer operate the business and was compelled to go into bankruptcy."

The testimony and the record clearly show that for a period of approximately nine months the deposits were punctiliously made pertaining to withholding tax, and that it was only for the months of January, February and March, 1958, that deposits were not made. The nature and extent under which the respondent was subject to the absolute control of the finance company is shown by his testimony at pages 51-53 of the Appendix:

"Q. Now, during the months of April, May, June, July, August, September, October, November and December of 1957, did your company pay or deposit into the special depository the withholding Social Security Tax?

"A. Yes, sir.

"Q. Where did the money come from for the making of these deposits?

"A. These still came from the advances made by the National Acceptance Corporation on the Receivables which were established upon the shipment of the merchandise.

"Q. Now, calling your attention to the months of January, February and March of 1958, what happened, Mr. Herman, with reference to the financing furnished by the National Acceptance Corporation?

"A. We had practically no problem until the beginning of January. Subsequent to that the National Acceptance Corporation started to hold back a greater amount of the portions of the receivables that they had. There was no exact amount on which they arrived at to indicate the full 75 per cent which we were expecting they would give us or a lesser amount. Towards the middle of February the amount that they

gave us was considerably curtailed. They then insisted on giving us monies for specified items, by that I mean, they would set up another demand upon us that we were to make up a list of our requirements daily and show it to them either by somebody coming to our office or having our bookkeeper go to their office with a list of what we needed the money for. They would either O.K. some of the items or delete other items. They would then say, we will give you money for that and on that basis we got the money. The monies that we asked for we seldom got in full amount. We were even told to leave off certain help that they didn't think this help was necessary or this party wasn't necessary and as a result the payrolls were reduced. About the middle of February I remember distinctly, after asking for the various necessities which we had to have, I also requested that the funds for the Social Security be allowed inasmuch as we had to put it in our depository."

• • •

"Mr. Lansing: You may proceed, Mr. Herman.

"The Witness: A. We got a considerably less amount than the 75 per cent and it was specified items which the National Acceptance O. Ked. As was stated before, I requested monies for many necessities including the Withholding Social Security Tax, in which case, as far as that tax was concerned, they said, to just let it go. He would answer next week we will speak about it and next week was the same; it was done every Saturday. The amount of money that was given was constantly reduced, in some cases in a haphazard manner. We would get some money some days and on other days nothing. We were forced to curtail our operation considerably and we let go personnel in the different departments. We just had no money to operate, we had no allowance given us so that we could continue.

"Q. Now, Mr. Herman, Mr. Bitran testified this morning that at one stage, I believe during the early

part of February, the National Acceptance Corporation came back there and opened up the mail by which you received your payments from your customers, is that correct?

"A. Yes, sir.

"Q. How was that one?

"A. Each day about 8:30 to 9:00 o'clock in the morning just prior to the time that the mail would arrive a Field man from National Acceptance's office would come in the office and be in the office until the mail came in and as soon as it was there he would put it on a table reserved for him and he went through all the mail and all the checks that were in it he would withhold and the other general mail like correspondence and requests or orders or adjustment and so forth he would turn over to the bookkeeper for general processing.

"Q. Mr. Herman, at or about the same time did the finance company begin to exercise any dominion or control over your bank accounts?

"A. Yes, sir.

"Q. Give the details?

"A. Soon after they started to request items regarding the list of our requirements upon which we would ask them for money, they would further, they would also be in touch with the American National Bank, so that around 12 o'clock, at that point, they would either allow or disallow the clearance of checks that were made for the various purposes which prior were requested and made out to us, and it was not an uncommon thing to have checks disallowed and returned, just returned, refused.

"Q. Mr. Herman, about how many times during the months of February and March, did you request the National Acceptance Corporation to release sufficient monies to pay the Social Security Taxes?

"A. I made this request from time to time, at least, once or twice during the week. Each week I

was in touch with them by telephone, practically every day, trying to get somebody over there to follow through on our request.

"Q. Did you at that time have any source of money with which to discharge the withholding Social Security requirements?

"A. No, there were no other funds available.

"Q. When did you come to me to report the situation of the finance company clamping down on your financial requirements and curtailing your business?

"A. Well, I come to you in March and told you that we were not getting our full financing.

"Q. After you reported that to me, isn't it a fact that you and I decided that we would come into Court and state that we could no longer operate because the finance company had pulled the plug and that we were compelled to go into this bankruptcy, isn't that correct?

"A. Yes, sir."

On cross-examination the respondent (Herman) testified as follows (App. 73-74):

"Q. Just one question, Mr. Herman, during the months of January, February and March of 1958, would it be fair to summarize what you stated concerning the relations of Glostex Products, Inc. and National Acceptance Corporation and your position with Glostex, that you had no discretion whatsoever to pay any funds to any supplier or any creditor?

"A. Yes, sir, that would be my conclusion.

"Q. Especially the United States Government, is that right?

"A. There would be no exception; I had no discretion whatsoever."

David Bitran, the accountant for the debtor in possession, testified as follows (App. 43):

> "Q. (Mr. Lansing): My last question, Mr. Bitran, have you witnessed Mr. Herman from time to time in the months of January, February and March of 1958, requesting or demanding of National Acceptance Corporation that they advance monies necessary current withholding Social Security taxes, did you overhear such conversations?
>
> "A. I did. I myself asked many times the men from the National Acceptance Company to give us enough money to pay current taxes; . . ."

The testimony of the respondent and Bitran is uncontroverted, the Trustee having offered no evidence whatsoever to the contrary. (See App. 33-76.)

Bearing also on the nature of the case and the remedy sought by the Trustee before the Referee is the doubt expressed by the Referee during the course of the hearing before him, as to his right to order the respondent, Irving Herman, to pay the funds requested by the Trustee's turnover petition (App. 40-41):

> "The Referee: I do not know whether I would have any authority to order the payment of the funds. There are other remedies in the violation of the statutes which would be the proper method to proceed in some other fashion. I would like to see that he had the money and that he paid his debt but this is a matter subject to some other process.
>
> "Mr. Lansing: Your Honor is assuming that you want another order directing the turn-over?
>
> "The Referee: No, I am not assuming such an order be entered; I don't want any order entered."

ARGUMENT.

I.

The Decision Of The Court Of Appeals, Affirming The Ruling Of The District Court, Will Not Encourage Debtors-In-Possession Not To Pay Their Withholding Taxes Or To Flout The Orders Of The Bankruptcy Court.

In its decision and opinion the Court of Appeals affirmed the findings and decision of the District Court, and found:

> (a) That the proceeding before the Referee was a turnover proceeding resulting in a turnover order;
>
> (b) That there was no diversion of any of the withholding tax funds by the respondent, Herman, for the personal use of the respondent;
>
> (c) That there was no allegation or proof that Herman had ever taken personal possession of the withholding tax monies in question, or that Herman was currently in possession of the same; and
>
> (d) That the failure of the respondent, Herman, to segregate and deposit the withholding taxes for the months of January, February and March, 1958, was *not*, under the particular circumstances of this case, a deliberate and wilful defiance of the District Judge's order, and did *not* constitute a wilful breach of any fiduciary duty by Herman.

It should be noted at the outset that the Director of Internal Revenue is *not* asserting any claim against the respondent, but against the Trustee having possession of trust funds properly belonging to the government under the concepts of Section 7501 of the Internal Revenue Code of 1954, sufficient in amount to fully pay said tax claim.

Sections 3402, 6672 and 7501 of the Internal Revenue Code of 1954, do *not*, it should be noted, give a cause of action to the trustee against the respondent for the debtor-in-possession's failure to pay the withholding taxes for the last three months of its operations, and the Trustee's attempt to convey the contrary impression in his Petition is both deliberately misleading and unfair.

In his Petition, the Trustee advances the completely specious, unwarranted and alarmist arguments that the import of the decision of the Court of Appeals and the District Court in the instant case is, to use the specious language of the petitioner, "that a bankruptcy court is powerless to supervise the acts of its own appointee" (incidentally, the order continuing the debtor in possession and authorizing it to retain the services of the respondent was entered not by the Referee but by the District Court Judge (App. 4), and that the opinion will result in Chapter XI arrangements becoming "a tax-free haven available to failing corporations," and will encourage other debtors-in-possession not to pay their taxes and to flout the orders of the bankruptcy court.

It would appear, based on the findings of the District Court Judge and the acceptance thereof by the Court of Appeals, that the Trustee's conjectural concern over the fancied evils flowing from the decision in this case, is apparently not shared either by the Court of Appeals or by the District Court Judge, whose interest in encouraging proper administration of bankruptcy proceedings is certainly, to say the least, at least equal to that professed by the Trustee.

There is nothing in the decision of the Court of Appeals in holding that "*under the circumstances of this case*, we hold that there was no willful breach of any fiduciary duty

by Herman", that warrants the alarmist inference of the Trustee that a Pandora's box will thereby be opened, or that the instrumentalities available to the Referee or the District Court Judge are not sufficient to enable the Referee or the District Court Judge to at all times adequately police the payment of withholding taxes. It is suggested that the Trustee's prosecution and persecution zeal is perhaps motivated not by any real belief that the decision of the Court of Appeals will be misconstrued or extended beyond the peculiar fact circumstances here involved, but by the frustration of having an estate where the priority tax status of the government leaves very little to cover the expenses of administration. Such frustration while understandable, is no justification for persecuting the unfortunate respondent, where the record clearly indicates that for 9 months he complied with the Court order regarding withholding taxes, and only stopped when the finance company took control of debtor-in-possession's finances and disbursements, and where the record unequivocally indicates that the respondent did not personally retain or benefit from said funds, and where the funds properly chargeable with said taxes have been and are in the possession and control of the Trustee.

II.

The Summary Proceeding Had Before The Referee In Bankruptcy, And The Referee's Order Directing The Respondent To Pay To The Bankrupt Estate Or The Director Of Internal Revenue A Sum Necessary To Satisfy The Withholding Tax Claim Of The United States Against The Bankrupt Corporation, Were In The Nature Of A Turnover Proceeding And Order, And Were So Correctly Construed By The Court Of Appeals And The District Court.

The initial question, then, is whether the Referee's order (See App. 76-78) was a turnover order. As the

Court of Appeals said in its opinion (see pages 3a and 4a of Appendix "A" of petitioner's Petition):

> "Initially, then, it must be determined whether the referee's order was a turnover order. In *Maggio* v. *Zeitz*, 333 U.S. 56 (1948), the Court speaks of a turnover order as being a remedy. Whether or not the order in the instant case is a turnover order is to be determined by the nature of the remedy contemplated by the order. The trustee's amended petition prayed for an order directing Herman to pay and, upon default, for a rule upon Herman to show cause why he should not be held in contempt. The referee's order directed Herman to pay the claim of the United States, and the trustee presumably, would have initiated a contempt proceeding had not the district court vacated the order. This is the exact remedy that was before the Court in *Maggio* which involved a contempt proceeding for failure to obey what is conceded to be a turnover order. Furthermore, here the parties considered the proceeding before the referee as a turnover proceeding. In a colloquy between counsel for Herman and the referee, the proceeding is referred to as "turnover." The trustee did not object to such denomination. We hold that the district court did not err in determining that the proceeding before the referee was a turnover proceeding resulting in a turnover order.
>
> "Further, *Maggio* v. *Zeitz*, *supra*, holds that a person against whom a turnover order has been directed may show in a subsequent contempt proceeding that he is presently unable to comply due to present lack of possession. In the instant case there was no allegation that Herman possessed the money in question nor was there proof that he had such possession. In discussing the history and nature of turnover orders the Court in *Maggio* pointed out that such orders were fashioned by bankruptcy courts to aid in prior administration by summarily retrieving the assets of the estate. Turnover orders are analogized to common

law actions for the recovery of possession, and the Court concludes by stating: "It is no sense based on a cause of action for damages for tortious conduct such as embezzlement, misappropriation or improvident dissipation of assets." *Id.* at 63. It follows that a turnover order may not issue without a showing of possession. 2 Collier, Bankruptcy § 23s10, p. 538 14th ed. 1956)."

Collier on Bankruptcy (14th Ed.), Volume 2, at pages 533-534, 536, in defining the nature of a "turnover order" states as follows:

> "One of the more frequent forms of the exercise of summary jurisdiction is the issuance of an order to turn over property or its proceeds to the supervision and control of the bankruptcy court and its officers, and is commonly called a 'turnover' order. Such an order may apply to any kind of property of the bankrupt estate, and will require the person affected to turn over the property in his possession or under his control to the receiver or trustee."
>
> * * *
>
> "The primary purpose of a turnover order is 'to get at property rather than get at the debtor', and while, as hereinafter noted, the order may extend to the proceeds of the property when sufficiently identified, the proceeding is 'essentially . . . for restitution rather than indemnification, with some characteristics of a proceeding *in rem;* the primary condition of relief is possession of existing chattels or their proceeds capable of being surrendered by the person ordered to do so.'"

Remington on Bankruptcy, Volume 5A, at pages 178 and 184, to 185, characterizes a "turnover order" as follows:

> "A turnover proceeding has at least some of the aspects of a proceeding in rem, being essentially one to effectuate the bankruptcy court's constructive pos-

session of the assets, or res, under administration. Such proceedings have, however, in the past, when directed to the bankrupt or to an officer or agent of the bankrupt, often assumed the character of an inquisition. . ."

. . .

"Such proceedings had come to be regarded in some districts as not merely a method of acquiring possession of property known to be in possession of the bankrupt, or an officer or agent of the bankrupt, but of 'putting on the screws' to require production of or accounting for missing or suspected assets under a presumption of possession and threat of contempt and languishing in jail until they were disgorged. The *Maggio* decision emphasizes the impropriety of this extortion method. . ."

The Referee's order of November 21, 1960, which was thereafter vacated and set aside by the District Court Judge, specifically directs the respondent, Irving Herman, to "pay to this estate or the Director of Internal Revenue, the sum of $9,634.18, or any greater or lesser sums needed to satisfy and discharge the claim of the Director of Internal Revenue." Said order does not purport to render a money judgment against the respondent; nor does it make such findings of fact and damages as would support a money judgment. It is purely and simply a *turnover order* improperly directing the respondent to pay funds *then in the possession of the Trustee* (subject to a trust fund in favor of the Director of Internal Revenue), and which funds admittedly were not in the possession or control of the respondent.

That the Trustee by his petition was seeking "restitution", one of the characteristics of a turnover order, and not indemnification, is also evident from the Reply Brief filed by the Trustee before the Referee in connection with

the proceedings before said court, where at page 7 of said reply brief the Trustee's counsel stated his position as follows:

> ". . . Respondent argues that no turn-over order should be entered or citation entered against him because the Trustee has not proved that Herman has the goods and proceeds sought within his possession. Obviously the situation to which the Respondent has reference is one wherein a creditor or third party is alleged to have identifiable property or a specific fund within his possession. Such is not the case here. Rather, it involves a question of determining whether Respondent owes this estate a specific amount, and, if so, *whether he should be compelled to make restitution.*" (Italics ours)

It is therefore respectfully submitted that the Court of Appeals and the District Court both properly treated the Referee's Order of November 21, 1960, as a turnover order, and properly set the same aside.

III.

The Court Of Appeals And The District Court Were Correct In Holding That The Debtor-In Possession's Failure To Segregate And Pay Withholding Taxes For The Last Three Months Of Its Operations Did Not Give Rise To A Cause Of Action, Cognizable In A Summary Proceeding Before The Referee, In Favor Of The Trustee Against The Respondent For An Alleged Breach Of Fiduciary Duty, Where As Here:

> **(a) None Of The Withholding Tax Funds Came Into The Personal Possession Of The Respondent, But Instead Were Used As A Part Of The General Funds Of The Debtor-In-Possession To Generate The Acquisition And Completion Of Merchandise And Accounts Receivable, And Then Turned Over In Full, Whether In The Form Of Cash, Merchandise Or Receivables, To The Trustee After The Debtor-In-Possession Had Been Adjudicated A Bankrupt.**

(b) There Was No Diversion Of Any Of The Withholding Tax Funds By The Respondent For The Personal Use Of The Respondent.

(c) There Was No Proof Or Evidence Of Any Loss Or Damage To The Bankrupt Estate, Or To Its Creditors, By Reason Of The Non-Payment Of Said Taxes.

(d) The Finance Company, Financing The Operation Of The Debtor-In-Possession And Having A First Lien On All The Assets Of The Debtor-In-Possession By Court Order, Virtually Controlled The Financial Affairs Of The Debtor-In-Possession During The Three Months Period In Question, And Controlled The Disbursement Of All Funds Of The Debtor-In-Possession During This Period.

(e) Respondent's Conduct In Relationship To The Debtor-In-Possession's Failure To Segregate And Pay Withholding Taxes For The Period In Question, Was Found Both By The Court Of Appeals And The District Court Not To Constitute A Deliberate and Willful Defiance Of The District Court's Order, And Not To Constitute A Willful Breach Of Any Fiduciary Duty By The Respondent.

(f) The Trustee Had No Lawful Interest In The Trust Funds Belonging To And Claimed By The Director Of Internal Revenue, And The Director Of Internal Revenue Is Not Asserting Any Claim Against The Respondent.

The Decision Of The Court of Appeals Is A Sound One Under The Particular Circumstances Of This Case, And Is Not In Conflict Either With The Decisions Of This Court Or With The Decisions Of Other Circuits.

In the instant case the Referee's turnover order improperly directs the respondent to pay to the bankrupt estate or the District Director of Internal Revenue withholding tax funds admittedly not in the possession or

control of the respondent, where the funds properly chargeable with said taxes were *then in the possession and control of the Trustee.*

Maggio v. Zeitz, 333 U. S. 56 (1948) is authority for and holds that the receiver or trustee must prove that the person proceeded against has either possession or control of the property or the proceeds demanded, and that in the absence of the same a turnover order will not lie.

In the present case there is no showing or evidence of such possession by the respondent. As the Court of Appeals said in its opinion:

> "In the instant case there was no allegation that Herman possessed the money in question nor was there proof that he had such possession. In discussing the history and nature of turnover orders the Court in *Maggio* pointed out that such orders were fashioned by bankruptcy courts to aid in proper administration by summarily retrieving the assets of the estate. Turnover orders are analogized to common law actions for the recovery of possession, and the Court concludes by stating: '*It is in no sense based on a cause of action for damages for tortious conduct such as embezzlement, misappropriation or improvident dissipation of assets.*' *Id.* at 63. It follows that a turnover order may not issue without a showing of possession. 2 Collier, Bankruptcy, Sec. 23.10, p. 568 (14th ed. 1956)." (Italics ours.)

In the present case the Trustee admittedly is not seeking to recover possession of withholding tax funds in the hands or possession of the respondent, but seeks by a summary turnover order to hold the respondent personally liable (without proof of any actual loss or damage to the bankrupt estate) for failure of the debtor-in-possession

to fully comply with the court order by failing to segregate and pay the withholding taxes for the 3 months in question.

Thus at page 3 of Trustee's Petition for Rehearing in the Court of Appeals this admission appears:

> "The trustee has not proceeded in this matter on any theory that Herman had certain specific funds in his possession which were earmarked or set aside for payment of withholding taxes."

It is respectfully submitted that the decision of the Court of Appeals for the Seventh Circuit in the instant case is a sound one, and not inconsistent with both the *Maggie* v. *Zeitz* case, *supra*, and the earlier cases of *May* v. *Henderson*, 268 U. S. 111 (1925); and *Rabinovitz* v. *Oughton*, 92 F.2d 297 (C.C.A. 3rd 1937), *certiorari* denied 303 U. S. 649 (1938); and *Reifsnyder* v. *B. Levy & Son*, 88 F. 2d 287 (C.C.A. 3rd 1937) cited by the petitioner.

While the *May* v. *Henderson*, and *Rabinovitz* v. *Oughton* cases, *supra*, are authority for the proposition that where a person proceeded against occupies a position which places him in a fiduciary relationship, or holds the assets of the estate in a position of trust, lack of present possession or control will be no answer to the turnover order, both of these cases recognize the elementary proposition that the property or funds sought to be recovered must initially and in the first instance, prior to their alleged unlawful disposition or transfer, have come into the possession and control of the respondent asked to account therefor. Both of these cases also recognize the principle "that the duty of a fiduciary to account for property entrusted to his care is fulfilled by delivery of the property."

Thus in *May* v. *Henderson*, 268 U. S. 111 (1924), at page 119 of the reported decision, the Supreme Court said:

> "*The duty of a fiduciary to account for property entrusted to his care is fulfilled by delivery of the property*, but if he has put it out of his power to deliver it, he may nevertheless be compelled to account for its worth. *United States v. Dunn et al.*, post, p. 121. He is subject to the summary order of the Bankruptcy Court to restore the property to the bankrupt's estate. If he has sold it or mingled it with his own, he may be compelled by summary order to restore the value of the property thus wrongfully diverted." (citing cases) (Italics ours)

It is submitted that the fact situation in the instant cause is clearly distinguishable from that involved in both the *May* v. *Henderson*, and *Rabinovitz* v. *Oughton* cases, *supra*. Both of those cases *involved* preferential payments, in one case by the Assignee-Trustee for the benefit of creditors on account of monies owing by the bankrupt to the assignee's bank, and in the other (the *Rabinovitz* case) by the president of the bankrupt company in payment of a personal loan owing by the bankrupt company to himself. In both of those cases, funds of the bankrupt were unlawfully diverted to effectuate preferential transfers in favor of the respondent sought to be charged by a summary turnover order. In both cases the funds sought to be recovered where shown to have come into the possession of the respondent sought to be charged in the summary turnover proceeding. In both cases the respondent sought to be charged in the summary turnover proceedings stood to personally profit by such unlawful preferential payments.

These factual factors are not present in the instant cause, where the evidence is uncontroverted that none of the withholding tax funds, which the debtor-in-possession failed to segregate and pay for the 3 months in question, came into the personal possession of the re-

spondent, but instead were used as a part of the general funds of the debtor-in-possession to generate the acquisition and completion of merchandise and accounts receivable, and then turned over in full, whether in the form of cash, merchandise or receivables, to the Trustee after the debtor-in-possession had been adjudicated a bankrupt; where the finance company, by court order, had a first and prior lien on all assets and funds of the debtor-in-possession, and controlled and regulated the disbursements of the debtor-in-possession during the 3 months in question; where to use the language of the District Court, "the record is clear he (Herman) derived no personal gain and in fact disbursed the money he received"; and where the Court of Appeals in its opinion found that "under the circumstances of this case, we hold that there was no wilful breach of any fiduciary duty by Herman."

Although the amount of the government's claim for withholding and social security taxes due for the last 3 months of the debtor-in-possession operation is in dispute (the government claiming $9,634.18, and the respondent asserting that the correct amount is $6,893.07), it is admitted by all parties that the fund on hand and in possession of the Trustee in the amount of $10,959.02 constitutes a trust fund in favor of the government for the payment of said claim, and which government claim is entitled to priority over all other debts afforded priority under Section 64 of the Bankruptcy Act. (See Referee's order of November 21, 1960, at page 78 of Appendix to that effect.) See also *U. S.* v. *Sampsell*, 193 F.2d 154 (C.C.A. 9th, 1951); *Hercules Service-Parts* v. *U. S.*, 202 F.2d 938 (C.C.A. 6th, 1953); and *In re Airline-Arista Printing Corp.*, 267 F.2d 333, 334 (C.C.A. 2nd, 1959) affirming 156 F. Supp. 403, 408 (1957), sustaining the application

of the trust fund theory to a situation such as is present in the instant case.)

The uncontroverted evidence in this cause indicates that there was no diversion of any withholding tax funds by the respondent for the personal use or benefit of the respondent, and that the reason why said taxes for the last three months of the debtor-in-possession regime were not paid was that the finance company, National Acceptance Corporation, commencing in January, 1958 reduced the amount of money being advanced to the debtor-in-possession, sequestered the mail of the debtor and withheld from the debtor all checks, exercised control over the bank account of the debtor-in-possession by allowing or disallowing the clearance of checks issued by the debtor and ignored frequent requests of the debtor to allow for the payment of the withholding and social security taxes.

It is evident that the failure of the debtor-in-possession to pay the taxes in question has not in any way diminished the bankrupt estate, but on the contrary has enhanced the estate by an amount which would not have been available to the trustee had the debtor-in-possession, had it been able to do so, paid said withholding taxes. Therefore, to the extent that the government asserts a trust fund priority to monies in the possession of the trustee, the trustee is merely paying monies in his possession (and not in the possession of the respondent) to which the trustee was not equitably entitled in the first instance.

That no real damage or loss would under such circumstances accrue to the bankrupt estate or its creditors is pointed out in *Hercules Service Parts Corp. v. United States*, 202 F. 2d 938, 941 (C.C.A. 6th 1953), where, as here, the debtor-in-possession had failed to pay withholding and social security taxes while operating as debtor-

in-possession, and where the Court in applying the trust fund theory in favor of the government to funds in the hands of the Trustee said:

> "While the assets of the estate have not been increased by the funds withheld, if restitution is made the creditors will receive no less than that to which they were originally entitled and that which they would have received if the officer of the law had performed his obligation."

See also *In re Airline-Arista Printing Corp.*, 156 F. Supp. 403, 408 (1957), affirmed in 267 F.2d 333 (C.C.A. 2nd—1959), where the District Court, in a similar situation, stated:

> "The estate must necessarily have benefited and the assets coming into the Trustee's hands have been increased to the extent of the funds withheld by the failure of the debtor to pay those funds over to the beneficiary."

As previously pointed out, the record in the instant cause is completely devoid of any proof of actual loss or damage to the bankrupt estate by reason of the failure of the debtor-in-possession to segregate and pay the withholding taxes for the last three months of its operation.

None of the cases cited in the Trustee's petition are in point, and the Trustee cannot point to a single case involving facts such as are present in the instant case as authority for his position. It is to be noted that in none of the cases where the Courts have sustained the application of the trust fund theory to a situation such as is present in the instant case (see *U. S.* v. *Sampsell*, *Hercules Service Parts* v. *U. S.*, and *In re Airline-Arista Printing Corp.* cases cited *supra*), has the managing

officer of the debtor-in-possession been personally surcharged or held personally liable to the Trustee for failure to pay withholding taxes where, as here, there is no evidence of any misappropriation of tax funds by said managing officer.

It would appear that since no dividend could possibly be paid to creditors of the bankrupt estate herein, that the Trustee's action is one which seeks to create an estate for the sole purpose of paying costs and expenses of administration. While we have no quarrel with the laudable desire of Trustee and his counsel to obtain compensation for their services rendered in the bankruptcy proceeding (and it should be remembered that counsel for the bankrupt has likewise spent and devoted hundreds of hours to this bankruptcy proceeding for which he cannot hope to be adequately compensated in view of the size of the bankrupt estate), nevertheless, it would seem somewhat incongruous to surcharge or hold the respondent liable for the taxes in question, when the monies properly chargeable with the same have been and are in the possession of the Trustee, and when it seems that the only purpose of this ill-conceived action by the Trustee would be to create an estate sufficient to pay more fees. Certainly the processes of the bankruptcy court should not be used to persecute an officer of an insolvent bankrupt company by the prosecution of an ill-conceived claim against him merely to provide additional fees for Trustee and his counsel.

CONCLUSION.

It is respectfully submitted that the decision of the Court of Appeals for the Seventh Circuit in the instant cause, affirming the decision of the District Court, is a sound one on its facts, and is not inconsistent with the decisions of this Court and the courts of the other circuits. Therefore no real or justifiable reason exists for the granting of *certiorari* in this cause.

Wherefore, respondent respectfully prays that petitioner's Petition for Writ of *Certiorari* in this cause be denied.

Respectfully submitted,

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